

# The Lawyers' *LAWYER* Newsletter

## Recent Developments in Risk Management

### Lawyers' Professional Liability (Malpractice) Insurance — Nondisclosures on the Application — Loss of Coverage for Misrepresentations

*Continental Casualty Co. v. Law Offices of Melbourne Mills, Jr., PLLC*, 2010 WL 996472 (E.D. Ky. 2010)

**Risk Management Issues:** What is the scope of the duty of disclosure in a lawyer's application for malpractice insurance? What are the consequences for failing to make adequate disclosure?

**The Case:** Defendant Mills and other lawyers represented more than 400 plaintiffs seeking damages for alleged injuries arising from use of the diet drug Fen-Phen (the "Fen-Phen Action"). In May 2001, following a successful mediation, Mills and co-counsel obtained a \$200 million settlement of the Fen-Phen Action. The Fen-Phen plaintiffs collectively received approximately \$74 million (37 percent) of the \$200 million settlement. Mills and other counsel and consultants received \$106 million, and \$20 million was used to form The Kentucky Fund for Healthy Living, Inc. (the "Fund"), which named Mills a director and paid him a salary.

In early February 2002, Mills became aware that the Kentucky Bar Association ("KBA") was investigating bar complaints filed against him related to the Fen-Phen Action. Shortly thereafter, Mills' counsel attended a hearing of the KBA's Inquiry Commission regarding an application for a *subpoena duces tecum* related to the Fen-Phen Action.

On August 21, 2003, Mills filed an application for renewal of his professional liability insurance with Continental Casualty Company for the 2003-2004 period. The Continental application requested information regarding any unreported claims and any disciplinary proceedings against lawyers in Mills' firm. Mills failed to disclose the investigation relating to the Fen-Phen Action on his 2003 application. When Mills submitted this answer, he had no reason to believe the KBA had terminated its investigation of his conduct in the Fen-Phen Action. After reviewing the 2003 application, Continental issued the policy to Mills' firm.

Later, plaintiffs from the Fen-Phen Action asserted legal malpractice claims against Mills and others in the case of *Abbott v. Chesley*, Case No. 05-CI-436 (Cir. Ct., Boone Cty. Ky.) ("*Abbott*"). The *Abbott* court ultimately ruled that Mills and others "breached their fiduciary duties to the Plaintiffs when they paid themselves fees over and above the amount to which they were entitled to under their fee contracts with their clients," and awarded the *Abbott* plaintiffs \$42 million dollars in compensatory damages.

Continental defended Mills against the *Abbott* litigation under a full reservation of rights, including the right to rescind the policy. Continental then sought a declaration that its policy did not provide coverage for the underlying action, arguing that Mills' conduct had caused: (1) the policy to be void *ab initio* or (2) the *Abbott* litigation to be excluded from coverage under a Kentucky statute that allows an insurer to rescind a policy, *inter alia*, if the policy is procured through misrepresentation, or if the insurer would have set a different premium or policy limit, or would not have provided coverage had correct information been provided.

The court determined that Mills' application which had resulted in Continental's issuing the policy contained misrepresentations satisfying the criteria for rescission of the policy. The court explained that Mills' answer to Question 4, which asked whether any attorney at the firm had been "disbarred, suspended, formally reprimanded or subject to **any disciplinary inquiry, complaint or proceeding** for any reason other than nonpayment of dues during the expiring policy period," was false because "Mills knew that a bar complaint had been filed against him in early 2002, and he admitted that as of the date he

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signed and certified the 2003 application, the KBA's investigation was ongoing." Mills was not only "aware that an investigation was ongoing, his attorney attended a hearing held by the KBA Inquiry Commission, which resulted in Mills being served with a *subpoena duces tecum* requesting records related to the Fen-Phen Action."

Mills attempted to avoid rescission of the policy by arguing that the filing of a complaint with the KBA was not sufficient to constitute a disciplinary proceeding or inquiry. The court rejected this argument, stating "The Rules of the Kentucky Supreme Court clearly state that the purpose of a *subpoena duces tecum* served by the Inquiry Commission is to direct the recipient 'to produce to Bar Counsel any evidence deemed by the Inquiry Commission to be material to the investigation of a complaint.'" Further, the court held that the fact that there was an ongoing KBA inquiry into Mills' actions with respect to the Fen-Phen Action was precisely the type of information Continental needed to evaluate its potential for current and future risk. Accordingly, the court held that Continental was entitled to rescind the policy.

**Risk Management Solution:** This case underlines the importance of total accuracy and completeness in the wording of lawyers' malpractice insurance applications. Any inaccuracy in an insurance application that may impair an underwriter's ability to assess risk and decide whether and on what terms to provide insurance may provide a valid basis for the insurer to disclaim coverage. Law firms should therefore make a comprehensive investigation of all lawyers to be covered by insurance before submitting each year's renewal application so the firm has confidence that the application is complete and accurate. Failure to do so can result in the firm losing the anticipated benefits of having insurance when a claim is made.

### Flat Fee or Advance Retainer — Lawyer's Treatment of Flat Fee Voluntarily Refunded to Client Results in Discipline *In re Mance*, 980 A.2d 1196 (D.C. 2009)

**Risk Management Issue:** May lawyers use "flat fee" arrangements to sidestep rules relating to non-refundable retainers? Are flat fees "earned on receipt," or must they be treated as advances against future fees?

**The Case:** In December 2003, William Saunders retained lawyer Robert Mance to represent Saunders' son, a suspect in a homicide case. Mance charged Saunders a fee of \$15,000, with \$7,500 due immediately and \$7,500 due after Saunders' son surrendered to the police. Mance further warned Saunders that, depending upon the investigation involved, Mance might require an additional \$5,000 for investigative services. Saunders made the initial \$7,500 payment. Mance deposited \$6,010 into his client trust account and the rest into his operating account.

Approximately one month later, Saunders terminated Mance, believing that he was not doing anything to help Saunders' son. Mance agreed to return the \$7,500, but did not do so immediately because he did not have the funds readily available. Saunders waited until May, then filed a bar complaint when he still had not received the funds. Mance paid Saunders the \$7,500 a week later, not realizing that Saunders had filed a bar complaint. Saunders contacted the bar and asked to withdraw the complaint, but bar counsel nonetheless brought formal charges against Mance, alleging (among other things) that Mance had misappropriated and commingled client funds.

After a hearing, the hearing committee held that the \$7,500 paid to Mance was a "flat fee" earned upon receipt (without regard to how much time was required), and not an "advance" that remained the property of the client until earned. In light of this conclusion, the hearing committee found that Mance had acted honorably by refunding the fees (with some delay), even though he was entitled to keep the fee. By depositing some of those funds into his client trust account, however, Mance had improperly commingled his own funds with client funds. The hearing committee recommended a public censure for this misconduct. The disciplinary board basically affirmed, and bar counsel appealed the case to the District of Columbia Court of Appeals, challenging the board's interpretation of the D.C. Rule of Professional Conduct 1.15(d)—patterned after Model Rule 1.15(d)—and application of that Rule concerning unearned fees.

Before the D.C. Court of Appeals, bar counsel argued that a flat fee is actually an advance of unearned fees and, like any other client funds, must be deposited into a client trust account. Mance argued, and Saunders agreed, that the \$7,500 was not client funds but the amount Mance intended to charge Saunders, no matter what services were performed.

The D.C. Court of Appeals rejected Mance's arguments. "Simply labeling a fee as something other than a flat fee or extreme 'frontloading' of payment milestones," the court explained, "will not excuse the lawyer from safekeeping the client's funds until it can reasonably be said that they have been earned in light of the scope of representation." Relying on § 38 of *Restatement (Third) of the Law Governing Lawyers* (2000), the court agreed with bar counsel's interpretation of Rule 1.15(d)—that fees paid in advance of services rendered remain the client's funds and must be treated as such "until earned unless the client consents to a different arrangement."

In considering *Mance*, it should be noted that states vary widely as to when they allow a payment for future services to become the lawyer's property prior to the rendering of such services. Many jurisdictions also regulate the use of "nonrefundable" fees.

**Risk Management Solution:** *Mance* is a reminder that ethics rules often impose serious impediments to a lawyer or law firm seeking to charge a "flat" fee for an engagement and treat that fee as nonrefundable and earned upon receipt. Lawyers should be careful when making such fee arrangements to know what is permitted under the relevant rules, to clearly communicate such fee arrangements to clients, and to handle prepaid fees in accordance with local rules.

## Responsibility for Representations Made Without Client Authority — Responsibility to Co-Counsel

*DePetris & Bachrach, LLP v. Srour*, 71 A.D. 3d 460, 898 N.Y.S.2d 4 (N.Y.App. Div. 1st Dept. 2010)

**Risk Management Issue:** Can a law firm be held liable to a second law firm when, without client authority, it promises that the client will pay the second law firm's fees?

**The Case:** According to plaintiff DePetris law firm, it had agreed to represent Srour based upon a representation from the Shibolet law firm that its client, the Nasser family, would pay \$75,000 in fees to DePetris for representing Srour. The Nassers failed to pay, and DePetris sued both them and Shibolet. Shibolet moved to dismiss DePetris' claims for breach of implied warranty of authority, tortious misrepresentation of authority, and assurances of payment. The trial court granted the motion and dismissed the claims.

DePetris appealed, and the Appellate Division reinstated its claims against Shibolet. The court concluded that DePetris' allegations that Shibolet had promised that the Nassers would pay \$75,000 when Shibolet had no authority to make this representation, and that Shibolet claimed it had specifically discussed the issue with the Nassers, stated viable claims for breach of the implied warranty of authority and tortious misrepresentation of authority and assurances of payment under New York law. Moreover, because the claims were stated against Shibolet directly, and not the Nassers, the fact that the Nassers had never stated to DePetris that Shibolet had authority to act on their behalf, and that no writing existed to take the promise out of the statute of frauds, were not valid defenses to the action. The deliberate nature of Shibolet's alleged acts also rendered any lack of consideration to the Nassers for the "promise" irrelevant. (The opinion also reinstated two other causes of action for reasons unrelated to this alert).

**Risk Management Solution:** Lawyers should take care to secure actual authority in writing before promising third parties that their clients will pay any fees. Failure to do so may cause the lawyers to incur direct liability if the clients later fail to pay as promised.

## Disclosing Information While Performing a Conflict Check — Conflict Checks Relating to Lateral Attorney Moves

ABA Formal Ethics Opinion 09-455 (October 8, 2009)

**Risk Management Issue:** What client-related information may a lawyer disclose for conflict-checking purposes to a firm considering the lawyer as a lateral candidate?

**The Opinion:** ABA Formal Opinion 09-455 examines what client-related information may be disclosed for conflict-check purposes when a lawyer is considering a lateral move to a new firm and the new firm is conducting its due diligence on the lateral candidate. The Opinion addresses the tension between the attorney's duty of confidentiality under Model Rule of Professional Conduct 1.6 and the potential lateral candidate's and potential new firm's obligations to detect and resolve conflicts of interest and to protect their clients' and former clients' interests.

Because a conflict check cannot be accomplished without sharing information generally about the clients and issues involved in a matter, the Opinion determines that, subject to certain limitations, the disclosure of conflicts information otherwise protected by Rule 1.6 should be considered permissible as necessary to comply with the Rules. In reaching this conclusion, the Opinion notes that the Model Rules are "rules of reason" to be "interpreted with reference to the purposes of legal representation and of the law itself." The key limitation is that the scope of the information shared with the potential new firm should be no greater than reasonably necessary to accomplish the purpose of detecting and resolving conflicts of interest.

By way of example, the ABA Standing Committee on Ethics and Professional Responsibility indicates that if the moving lawyer's current firm and the prospective firm are adverse in a number of existing matters, or regularly represent antagonistic groups, then further discussions and disclosures are likely unwarranted. Sometimes, however, resolving whether a lawyer's move to a new firm would require a fact-intensive analysis of information beyond the identity of the persons and issues involved in a representation. In those circumstances, if the firm cannot resolve the question based upon information available from other sources, then the moving lawyer must forego the move unless a permissible alternative method for detecting or resolving potential conflicts exists consistent with Model Rule 1.6 or, if screening is permitted, Rule 1.10.

**Risk Management Solution:** When considering a lateral hire, law firms should take great care to ensure that only information reasonably necessary for a conflict check is shared, and that the information shared is used only for conflict-checking purposes.

## Responsibility for Websites Lawyers Claim or Endorse — Soliciting Endorsements Including for Websites

South Carolina Ethics Advisory Opinion 09-10

**Risk Management Issues:** If a third party creates a website, when does a lawyer become responsible under the ethics rules for the content of that site? If a third party posts a comment about a lawyer on a website that a lawyer has adopted or endorsed, is the lawyer responsible for the contents of such a posting?

**The Opinion:** Advisory Opinion 09-10 examines legal issues relating to a website company ("Company X") that unilaterally creates websites containing lawyer profiles. These websites include a rating for each listed lawyer. Individual lawyers can "claim" their profile and update and supplement the information Company X has posted.

Lawyers can also write peer comments on other lawyers' profiles. Such peer comments affect a lawyer's rating. A lawyer may choose to retain or remove peer comments from his or her public profile.

In addition, anyone may submit a client comment and rating for a listed lawyer. Client ratings do not affect a lawyer's rating, but client comments are "prominently posted on the attorney's listing."

The Advisory Opinion posits two questions:

- (1) May a South Carolina lawyer claim his or her Company X website listing, including peer endorsements, client ratings and Company X ratings?
- (2) May a South Carolina lawyer invite peers, clients or former clients to post comments and/or rate the lawyer?

The Opinion offers the following responses:

- (1) Yes, a lawyer may claim the website listing, but all information contained therein (including peer endorsements, client ratings and Company X ratings) is subject to the rules governing communication and advertising once the lawyer does so.
- (2) A lawyer may invite peers to rate the attorney and may invite and allow the posting of peer and client comments, but all such comments are governed by the Rules of Professional Conduct, and the lawyer is responsible for their content.

**"Claiming" Websites:** In answering the first question about claiming third-party websites, Advisory Opinion 09-10 begins with the premise that a lawyer is "not responsible for statements about the lawyer or the lawyer's practice that are not placed or disseminated by the lawyer." Thus, statements about the lawyer made by Company X are "governed by the Rules of Professional Conduct" only when "placed or disseminated by the lawyer or by someone on the lawyer's behalf."

The Opinion distinguishes between communications about the lawyer's services that the attorney directly or indirectly makes, places, disseminates or endorses—for which the lawyer has responsibility under Rule 7.1—and those that the lawyer does not make, place, disseminate or endorse – for which the lawyer does not have responsibility.

Having made this distinction, the Opinion relies on prior South Carolina ethics opinions (addressing client sites that promote a lawyer's services and internet-based lawyer-finder services) and concludes that a lawyer "place[s] or disseminate[s] all communications made at or through that [website] after the time" he or she claims the website. *Id.* "By claiming a website listing, a lawyer takes responsibility for its content and is then ethically required to conform the listing to all applicable rules." *Id.* According to the Advisory Opinion, however, claiming a website requires greater interaction than simply correcting or updating directory information on the site.

The Opinion also warns that, once a lawyer claims a site, he or she should monitor the site to ensure that its contents comply with the Rules of Professional Conduct. "If any part of the listing cannot be conformed to the Rules (*e.g.*, if an improper comment cannot be removed), the lawyer should remove his or her entire listing and discontinue participation in the service." *Id.*

**Soliciting Peer and Client Comments:** Advisory Opinion 09-10 next analyzes whether a lawyer may solicit positive comments from clients and lawyers for a website profile. The Opinion relies on the long-standing practice of lawyers rating lawyers (*e.g.*, for Martindale-Hubbell) and case law dealing with constitutional protections for referencing such ratings to conclude that a lawyer may help build a rating and may reference that rating in other settings. *Id.*

Advisory Opinion 09-10 then considers a lawyer's solicitation of client comments. Here, the Opinion deals with a somewhat unique aspect of South Carolina ethics law that distinguishes between a testimonial, or a statement "by a client or former client about an experience with the lawyer," and an endorsement which is a, "more general recommendation or statement of approval of the lawyer." Noting that South Carolina's version of Rule 7.1 generally prohibits the use of client testimonials and also general endorsements, the Opinion advises, "A lawyer should not solicit, nor allow publication of, testimonials. A lawyer should also not solicit, nor allow publication of, endorsements unless they are presented in a way that is not misleading nor likely to create unjustified expectations." Having given this warning, the Opinion adds that an appropriate disclaimer or qualifying language "may preclude a finding that a statement is likely to create unjustified expectations or otherwise mislead a prospective client." *Id.* (emphasis in original).

Finally, Advisory Opinion 09-10 warns that a lawyer may violate not only the advertising rules but also Rule 8.4(a) through the acts of another, if a communication posted or adopted by the lawyer is "false, deceptive or is misleading."

**Risk Management Solutions:** Lawyers and law firms should expect to be held responsible for all information on any website when the lawyer or firm provides information to or solicits information for the site. Firms should therefore develop and enforce policies requiring lawyers to review sites they adopt or endorse for compliance with the ethics rules, and regularly monitor such sites to ensure that the content complies with the ethics rules.

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